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No. 84-192

In the Supreme Court of the United States

OCTOBER TERM, 1984

MERRILL N. BRADLEY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Petitioners contend that amounts received by them under a real estate sales contract, although denominated in the contract as interest on a mortgage note, were in reality payments on an unexpired option, and hence did not represent income taxable to them during the years in question. Both courts below rejected petitioners' attempted recharacterization of the sales transaction. Those decisions are correct, the question is essentially factual, and there is no circuit conflict or other circumstance warranting this Court's review.

1. Petitioners were co-owners of 320 acres of land in Alabama (Pet. App. 2a-3a). On July 30, 1974, they negotiated and signed a contract to sell the property. The buyer organized a limited partnership and assigned his interest in the contract to it (*id.* at 3a).

The contract provided that $51,200 in prepaid interest would be transferred to petitioners at the closing in 1974 (Pet. 5). The balance of the purchase price was evidenced by a nonrecourse note in the amount of $640,000 (2 R. 99). The note called for five annual interest payments, each in the amount of $51,200, to be followed by six annual payments combining interest and principal (Pet. 5; Pet. App. 3a). To secure these payments, the buyer executed a mortgage deed on behalf of the partnership (Pet. App. 3a). The mortgage deed covered the land for the full purchase price. It also contained an exculpatory clause that absolved the purchasers of any personal liability and limited petitioners' remedy, in the event of default, to foreclosure (*ibid.*).

The partnership received the deed to the property and title of record was put in its name (Pet. App. 3a). The partnership took possession of the land, and, for the next four years, made annual payments of mortgage interest and real estate taxes (*ibid.*). After making several attempts to sell portions of the property (Pet. 11), the partnership in 1979 defaulted on the mortgage note. Petitioners thereupon took delivery of the deed under an escrow agreement and record title was returned to them (Pet. App. 3a).

On their income tax returns for 1974 through 1976, petitioners reported the $51,200 annual payments that they received under the sales contract as

interest income. In 1977, however, they filed claims for refund, contending that the real estate transaction, while formally structured as a sale, was actually an option agreement, and that the annual payments, while denominated interest, were actually payments made by the buyer to keep open a right to purchase the land in the future (Pet. App. 4a). On petitioners' theory, the annual payments they received would not be currently taxable, since the supposed "option" had neither expired nor been exercised as of 1976 (*id.* at 3a-4a).

Upon the Commissioner's denial of their refund claims, petitioners filed suit for a refund in the United States District Court for the Northern District of Alabama. That court, in a bench opinion, held that the real estate transaction was in fact a sale and that the amounts petitioners received during 1974-1976 were interest payments, as specified in the sales contract (App., *infra*, 1a-10a). The court found that the purchase price stipulated in the contract, while in excess of the realty's actual market value, was believed by the purchasers at the time to be fair (*id.* at 4a). The court noted that both parties to the contract had treated the transaction as a sale and not as an option: the buyer took possession of the property, paid taxes on it, and realized rental income from it during 1974-1979 (*id.* at 4a-5a). The court accordingly held that the amounts petitioners received were currently taxable as interest income and that they were not entitled to a refund.

The court of appeals unanimously affirmed (Pet. App. 1a-6a; 730 F.2d 718). It held that petitioners could challenge the form of their transaction only by adducing proof that would suffice to alter the con-

struction of the agreements in a suit between the signatory parties (Pet. App. 5a-6a). Since petitioners had introduced no such evidence, the court held that, for tax purposes, they were bound by the transactional structure they had chosen, and that the payments in question were interest as provided in the agreements (*id.* at 6a).

2. The decision below is correct. In support of their contention that the real estate transaction should be taxed as an "option contract" rather than as a sale, petitioners rely (Pet. 12-19) on the familiar doctrine that substance rather than form governs for tax purposes. Their reliance is misplaced. To begin with, petitioners failed to convince the courts below that their transaction effected an option *either* in substance *or* in form. The district court found that "the realities of this situation and this transaction are far closer to that of the traditional sale of property than of the traditional optioning" (App., *infra*, 4a). The court noted that the parties had behaved as if the partnership really had bought the land, since the partnership took possession of the property, occupied it continuously for five years, derived rental income from it, and paid property taxes on it (*id.* at 4a-5a).

Moreover, even if petitioners had proved that the transaction was in substance an option contract, their argument ignores this Court's repeated holdings that the "form vs. substance" doctrine is not necessarily a two-way street. It is of course well established that the Commissioner may pierce the form of a transaction and insist that its tax consequences follow its economic substance. This doctrine is based on the fact that "taxpayers have it within their own control to choose in the first place whatever arrange-

ments they care to make" (*Commissioner* v. *Danielson*, 378 F.2d 771, 774-775 (3d Cir.), cert. denied, 389 U.S. 858 (1967)). As a result, "the Government may not be required to acquiesce in the taxpayer's election" (*Higgins* v. *Smith*, 308 U.S. 473, 477 (1940)). But this Court has repeatedly held that taxpayers, unlike the Commissioner, are not at liberty to disavow the form of their own transactions, and that the Commissioner may insist that taxpayers be bound by the structural arrangements they have freely chosen. See *Higgins*, 308 U.S. at 477. Accord, *e.g.*, *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 579-580 (1977); *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 147 (1974); *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *Old Mission Portland Cement Co.* v. *Helvering*, 293 U.S. 289 (1934). Here, the transaction was plainly arranged as a sale and, consistently with the terms of the sales contract, petitioners received interest income.[1]

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[1] Contrary to petitioners' contention (Pet. 20-22), the decision below does not conflict with *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976), for there it was the Commissioner, rather than the taxpayer, who challenged the form of the transaction, successfully contending that a purported sale of property lacked substance. The other cases upon which petitioners rely (Pet. 15-16) are likewise inapposite. *Helvering* v. *F. & R. Lazarus Co.*, 308 U.S. 252, 254 (1939), stands simply for the proposition that the right to claim depreciation on property is held by the one who must "bear the burden of exhaustion of capital investment" and does not necessarily follow legal title. In *Bartels* v. *Birmingham*, 332 U.S. 126, 130 (1947), the Court held that "the total situation," and not merely a contract of employment between two parties, controlled the imposition of liability for payment of employment taxes. As the Third Circuit noted in *Danielson*, 378 F.2d at 778, both of these cases dealt

As the court of appeals recognized (Pet. App. 5a), taxpayers have been permitted to escape the tax consequences dictated by the literal form of their transactions in certain rare cases where such a course is necessary to prevent unjust results. Such situations, however, are limited to those in which the taxpayer establishes grounds (such as mistake, undue influence, fraud, or duress) that would be sufficient in an action between the parties to reform or set aside the contract. See, *e.g.*, *Spector* v. *Commissioner*, 641 F.2d 376 (5th Cir.), cert. denied, 454 U.S. 868 (1981); *Sullivan* v. *United States*, 618 F.2d 1001, 1007 (3d Cir. 1980); *Danielson*, 378 F.2d at 775. As the court of appeals noted here (Pet. App. 6a), petitioners submitted no such evidence.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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SEPTEMBER 1984

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with situations where a "discernible policy" independent of the parties' agreements controlled the taxation of the transaction; no such policy is present here. Similarly, in *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481 (1937), the issue was not "form over substance" but the construction of an agreement whose provisions were inconclusive on their face.

(Break held.)

THE CLERK: Come to order, please.

THE COURT: The Court will now dictate findings of fact and conclusions of law. These are based upon the stipulations entered into by counsel both in writing and as stated in open Court and upon the evidence that has been presented in open Court consisting of testimony of witnesses and the reception of various documents. These two cases consolidated for trial involve claims for refund of income taxes paid by the Bradleys in the years 1974, '75 and 1976 totaling some $33,000 plus interest, and by the Plaintiff Murray in the calendar year 1974 totaling some 15 odd thousand dollars plus interest. At the center of this dispute is the taxability of payments received in the various calendar years by the taxpayers under or by virtue of a real estate transaction entered into in September 1974. In essence the Plaintiffs assert that the payments that were received are not to be treated as income in the years in which received because they constituted payment being made or received during the term of an option which did not expire, lapse or be exercised during any of those calendar years. The Defendant on the other hand asserts that these amounts are due to be taken into income as ordinary income in the years in which received because they constituted interest or in the alternative constituted payments for one year options, each of which expired during the years in question. The basic facts are not very complicated and indeed are largely covered by the stipulation and the documents attached to the stipulation.

In September 1974 the Plaintiffs executed a general warranty deed to acreage in Jefferson County

with no promise to pay the agreed upon purchase price being given by the grantee. The stated purchase price as had been agreed to in July of 1974 was $2,000 per acre for a total of $640,000, but upon the provision that there was no personal obligation on the part of the purchasers to make those payments and that their obligation or responsibility was limited to the potential loss of ownership interest in the subject property. Accordingly when the transaction was closed in 1974, there was given by the purchaser a mortgage and a mortgage note, the terms of which however recited that there was no personal obligation or responsibility of payment and that, in the event of default, the seller's remedy would be limited merely to in effect a foreclosure of the mortgage. Actually the parties made a further agreement in order to cut off possible rights of redemption that might have existed had there been a foreclosure of the mortgage and at the time of closing the purchaser executed a deed in favor of the Plaintiffs to the subject property and signed an escrow agreement under which that deed in lieu of foreclosure could be delivered to the Plaintiffs in the event of default under the mortgage. In fact, default did take place under the mortgage in 1979 with the result that in '79 after demand and after lapse of the stated period of time, the deed in lieu of foreclosure was given by the escrow agent to the Plaintiffs who thereupon recorded it and were reinvested with full title to the property. There were provisions in the mortgage dealing with release of properties from the lien of the mortgage and indeed in the year 1978 some acreage was released from the mortgage by payment on principal. It is perhaps of interest that in 1978 in connection with that release the Plaintiffs

and their attorney for the first time rather explicitly used the words "option" to describe the nature of the transaction that had been entered into back in 1974. The interesting feature is that this occurred after the events of 1977 which had been the year in which in effect tax refunds had been sought by the Plaintiffs on the basis that these payments that had been received and had been reported by them as income should not have been reported as income but should be treated as untaxable option payments.

There are basically two reasons why the Plaintiffs assert that notwithstanding the formalities of a warranty deed and in fact the delivery of a mortgage that they nevertheless had entered into an option agreement. The two facts basically are these: First, that there was no obligation or personal responsibility on the part of the purchasers to make full payment and indeed they could "walk away from the transaction when they desired to do so without further responsibility." The second basic fact asserted by the Plaintiffs in support of their position is that the stated purchase price of $2,000 per acre was far in excess of the then fair market value of the property and hence gives credence to the view that what was really intended by the parties was no more than an option agreement speculating upon the appreciation in the value of the property.

I do find from the evidence that the stated purchase price of $2,000 per acre was substantially in excess of the true fair market value of the property in 1974, although I also find that the purchaser of the property in 1974 did not realize that the price stated was greater than the actual value of the property. I find in favor of the Defendant in this case. There was in fact a true transfer of title and

ownership to this property. It was a closed transaction in the eyes of the Internal Revenue laws, notwithstanding the fact that there were matters of choice left open to the purchasers in terms of their future conduct. Not only were the formalities of sale adhered to, including the wording of the deed from the Plaintiffs to the purchaser and the recording of that deed, but moreover the grantee was placed in possession of the property and had possession of that property until the events of 1979. During that period of some five years, the grantee received some income from the property by way of rental income and apparently paid taxes on the property or at least was obligated to do so by virtue of terms of the mortgage.

There really is not much more to say than that the Court must reach the conclusion as it does that there was a closed transaction and that the realities of this situation and this transaction are far closer to that of the traditional sale of property than of the traditional optioning, purchase of an option. Some debate has gone on concerning the actual terms or meaning of some of the terms of these agreements. The witness for the Plaintiffs has candidly acknowledged that in the drafting of these agreements there was no understanding at the time of the difference in tax consequences between option payments and other matters, so that this was not a situation in which there was the careful tailoring of a transaction in such a way as to make clear—if that in fact was what was intended—that an option was intended. Indeed the evidence before me is that the purchaser was quite insistent that the transaction take place in the form in which it ultimately did, namely, as an actual sale and with the pay-

ments that were to be made being treated by the parties as interest payments, the terms of the note designating those payments as interest. As long as they were in fact paid, they were in fact interest payments, even though the purchaser could walk away from the transaction without further responsibility.

The Clerk will be directed to enter judgments in favor of the Defendant in each case. Costs are taxed against the Plaintiffs. It may be because I have not attempted to cover each and every detail that counsel wish me to cover and make a specific finding of fact on some matters that I have not addressed and I will be happy to do that or it may be that in the course of this recitation I have made an inadvertent slip of the tongue and if so I will be happy to give any correction to any such matters.

MR. BRADLEY: Your Honor, if I correctly understood you, you said that you found that the first time the word "option" was used was in 1978?

THE COURT: In terms of formally using them in the agreements. I believe that is what I indicated.

MR. BRADLEY: Mr. Murray raised the question that he was getting nothing but an option from the very beginning. He called them options in 1974.

THE COURT: If I in my findings indicated that the word had never been used before, I would certainly be in error under this evidence. I had reference to the use of that word or that terminology in the legal documents between the parties and I believe I am correct that in the legal documents between the parties, there was never any use of the word "option" until the 1978 agreement after there had been this petition or amendments claiming refunds.

MR. BRADLEY: Your Honor, that is true, but the word "option" does not have any limited meaning in the law according to Corpus Juris Secundum.

THE COURT: I am really interested at this point as to whether I have failed to address some factual matter.

MR. BRADLEY: Well, I am calling your attention to the fact that Mr. Murray said he was getting nothing but options from the very beginning. 1974, the first day he talked to Thompson—

THE COURT: The Court will—

MR. BRADLEY: —because there was no promise to pay.

THE COURT: The Court will make this further finding of fact that the sellers economically speaking were in no substantially different position than what they would have been in by virtue of an option agreement, the only substantial economic difference turns out to be the taxable consequences which as I view it from a tax standpoint they didn't get an option or give an option; they sold the property.

MR. MURRAY: Your Honor, I wonder if you could make a finding that there was no debt.

THE COURT: That is a matter—

MR. MURRAY: That is what we think our case hangs on and we would like for you to find—

THE COURT: I would not find that. I find that there was a debt in the stated amount of the promissory note as it from time to time was affected either by payments of interest or by ultimately in 1978 some payment on principal but that it—that that was enforceable only as against the property itself.

MR. MURRAY: And the property itself was not adequate in value to equal the option price.

THE COURT: In 1974, it was not.

MR. MURRAY: Yes, sir. Now your findings don't say anything about the deeds of release which were in the agreements from the very beginning that it was anticipated there would be a first deed of release and subsequent deeds of release right from the beginning and that that is the only way that he could get the property from the vendor's lien, the mortgage lien or from escrow. Could you say something about that?

THE COURT: It was anticipated that properties would be released from the security of the mortgage upon payment of principal as described in the mortgage and by means of the execution of one or more deeds of release indicating that the properties were being released from the security of the mortgage or in effect there was a partial satisfaction of that mortgage releasing the properties from the lien of the mortgage.

MR. KELLAR: Your Honor, at the start of your findings, I believe you said that there was no promise to pay. The Defendant would submit that that is an error and perhaps that was an inadvertent comment. Both notes which have been stipulated clearly recite that there is a promise to pay. It says, "The undersigned promises to pay to the order of Earle B. Murray and Merrill Bradley," et cetera, et cetera. Perhaps the findings which would be more appropriate would be, "There was a promise to pay but no personal liability on that promise."

THE COURT: That would be a fair statement. It tends to be to some degree a matter of fine semantics. There was a stated promise to pay but there was no personal obligation to see to the fulfillment of that promise and only the property and its value stood as security for that promise.

MR. MURRAY: Your Honor, could you say anything about the fact that there was a conditional delivery only for title insurance purposes to issue and that the deed was to go in escrow, and let me finish my question. And that between the parties the escrow agreement was binding and that the deed was released in order to have mortgagor/mortgagee title insurance at the time of the closing rather than when deeds of release were executed.

THE COURT: The deed from the Plaintiffs to the purchasers in 1974 was not at the time or immediately after execution delivered personally to the grantee named therein. It was, however, delivered to a title insurance company with the expectation that that would be recorded which it in fact was. After the recording, the deed from the Plaintiffs to the grantee was returned to the title insurance company and by it given to the grantee's attorney. I do not find that the grantee's attorney in receiving that deed received it in any kind of escrow arrangement. The only deed which I find that the escrow agent held as escrow agent was the so-called deed in lieu of foreclosure which was to be released by the escrow agent either back to the grantor therein, the purchaser of the property or to the Plaintiffs herein, depending upon whether or not the mortgage was fully paid.

Are there other questions about particular findings of fact?

(No response.)

THE COURT: All right.

(All proceedings ended on November 17, 1982, at approximately 1:00 p.m.)

I certify that the foregoing is a correct transcript from the record of proceedings in the above-entitled matter.

/s/ Mayra B. Malone

MAYRA B. MALONE, RPR
Federal Official Reporter

April 16, 1983
Date

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